March 17, 2013

Dr. Ryan Streeter
Senior Economic Policy Director
Office of Governor Mike Pence
The Statehouse, Room 206
200 W. Washington St.
Indianapolis, IN 46204

Dear Ryan:

This is in response to your request for my opinion regarding the relative merits of cutting different state taxes based on their impact on the growth and economic development of the state. As I am sure you realize, cutting taxes at a state level has a different basis for analysis than at the national level. There is no question that states compete with one another and that the level of state taxes is one of the important determinants of business location and the growth of a state economy.

As I understand it, the debate in Indiana is between the acceleration of a phase out of the estate tax and a reduction in the state income tax. In my opinion, there is no question that a reduction in the income tax would have a bigger positive impact on business development, state economic growth, and employment than would a dollar-for-dollar reduction in the estate tax.

There are a number of reasons for this.

First, business formation is almost always undertaken by individuals who are in their prime earning years and therefore doubtless anticipate that they have, at most, a small probability of being subject to any taxes levied at death. Estate planning generally happens upon retirement. At that time individuals may often opt to relocate their residence to a state with lower, or possibly zero, death taxes. But in this event the business has already been formed and growth and is generally then sold when the owner retires, leaving no impact on location.

Second, as roughly 90 percent of the businesses in the state of Indiana are pass-through entities where the profits are taxed at the individual level, state income taxes directly reduce the cash flow of existing businesses. The largest component of an owner's draw from his or her business is to pay federal and state taxes. Therefore a reduction in the level of state income taxation leaves more cash flow in the hands of the owner to be deployed as he or she sees fit.

Third, state income taxes are a direct and immediate component of the cost of living for a company's employees. Attracting talented individuals who may have to move across state lines is an important component of operating a business, particularly a new or rapidly growing business. State income taxes therefore directly affect the employment costs a firm faces. There is no indication that death taxes are taken into account in worker relocation decisions since generally they, like the business owner, are not at an age where they are arranging their affairs in anticipation of death.

This is not to say that a gradual reduction in the state death tax in Indiana is a bad thing. A number of businesses, particularly family farmers, are burdened by the need to plan for passing their businesses on to their heirs. But the plan that is now underway in Indiana to eliminate the state death tax over the next few years is a very appropriate way of handling this issue.

One final point: regardless of which tax one is talking about, one of the key objectives of the State of Indiana should be to have all of its taxes below the level imposed by other states. Location decisions for businesses usually involve location choices in relatively close proximity to one another. So, planners in Indiana should strive to maintain a significantly lower rate (2 points or so) on both business and personal income taxes than neighboring states like Ohio, Illinois, and Michigan.

I hope this is helpful.

Best regards,

Larry Lindsey

Sent by email.